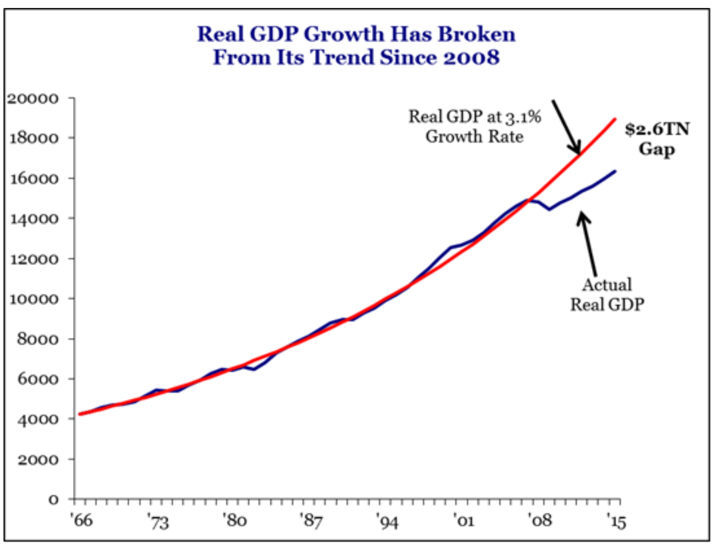
Toto, I've a feeling we're not in Kansas anymore . . . .
Dorothy, Wizard of Oz, 1939

Ever since the financial crisis of 2008–09, economic trends in the U.S. and in many foreign countries have not produced the growth expectations that most economists have projected. Indeed, various economic data has not followed normalized recovery patterns for quite some time.

As Chart I demonstrates, actual real GDP growth rates have been significantly below the 50 year trend. The break occurred in 2008, coinciding with the global financial crisis. Many experts argue that this reflects a number of factors, such as technology gains, shifting demographics and a cautious consumer. However, these kinds of issues have been present throughout the past 50 years, and trend line growth has never materially waivered. We believe that the explanation is more likely that the Federal Reserve (for the first time in history) embarked on a policy of aggressive quantitative easing. By artificially putting interest rates well below normal for an ***extended time period***, they injected a huge amount of liquidity versus past easing cycles. We could argue that this approach has inflated equity and other asset valuations, which could lead to the formation of bubbles. However, we can also argue that this effort has held back valuations due to sluggish growth in global GDP. Regardless of valuation issues, Chart I suggests that the implementation of these aggressive easing policies has slowed the growth in real GDP. While the final outcome will not be known for a number of years, it is clear that artificially lowering rates for an ***extended period of time*** has caused some amount of unknown consequences that we will be forced to deal with in the future.

Chart I



Source: Strategas

We like to read many thoughtful analyses on global economics. However, we have not found one to help clarify the subpar economic growth issues until we read the recent interview that Bill Gross (of Pimco fame) gave to Barron's on April 9, 2016. Bill opined that the classical method used by Central Banks of raising interest rates to slow inflation and GDP growth or lowering interest rates to accelerate GDP growth and inflation is no longer working when interest rates are near or below zero.

Under normal interest rates, the overall stock market return over long periods of time has been 8% on average. But with interest rates so low and GDP in the U.S. closer to 2% than 3%, long term returns are likely to be below the historic averages. We believe that Bill is right. With interest rates on a global scale so low, the impact of stimulating growth is no longer as effective as during normal interest rate cycles.

In the late 1970s, we suffered from massive inflation. In 1980, Paul Volcker, the Federal Reserve Chairman at the time, initiated significant increases in interest rates to break the back of the inflation spiral. This created a sharp, painful twin recession between 1980-82. However, it also set the stage for a massive economic and stock market recovery that spanned almost 15 years.

The current Federal Reserve Chairman, Janet Yellen, is trying to bring interest rates back to normal. But this "go slow" strategy may take years. The Fed does not want to create a negative economic environment by raising rates too quickly, and has thus adopted a policy of gradualism. While this will probably help us avoid a bear market in the near term, it will also delay a return to a more normal 3-3.5% GDP growth. In the meantime, the Fed continues to feed the asset bubble by maintaining its excessive easy money policies. Additionally, the absence of a fiscal policy stimulus from Congress is further delaying the prospect of right sizing the growth in the U.S. economy.

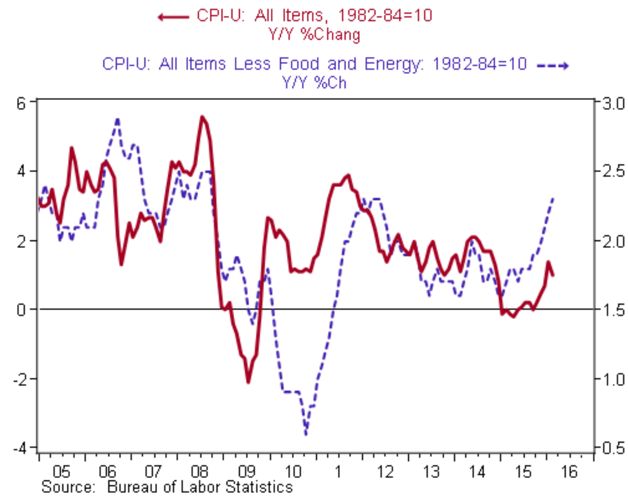
Thus, we find the U.S. stuck in a low growth environment. The prospect of modest increases in interest rates, combined with limited fiscal policy stimulus, should result in subpar GDP growth for a number of years. This also suggests that dividend paying equities, particularly ones yielding in excess of the 2% market average, should continue to appeal to investors.

Implications to the Equity Market

The sharp stock market correction in the first 45 days of 2016 was rapid and painful. Many components of the market suffered bear market trends (down 20% or more) in a short span of time. Some, such as Financials and Master Limited Partnerships, have not fully recovered, despite the strong recovery in the market overall. The sharp decline reflected collapsing oil prices, fears of a global recession, the December rate hike, as well as talk of an additional four rate hikes in 2016 by the Fed.

The swift recovery in stock prices reflected a reduction in the number of expected rate hikes in 2016, as well as the possibility of oil price stabilization due to a rumored production freeze. These two events, in tandem, would lessen the probability of a recession in the U.S. Concurrently, economic data from China also suggested that this critically important global market may finally be stabilizing GDP growth to around 6-6.5%. In the U.S. we also began to see wage growth in a tight labor market. The FOMC's goal of 2% inflation might finally be in sight by year end. This trend can be partly measured by the consumer price index.

Chart II

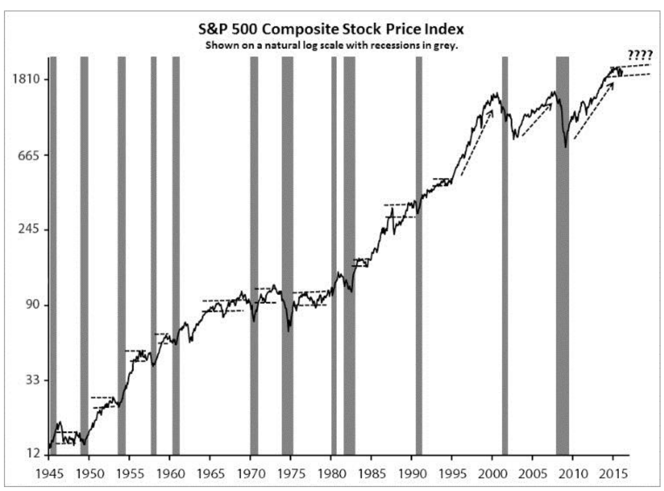


As Chart II demonstrates, the consumer price index has jumped recently (after adjusting for food and energy). The CPI is now reaching levels achieved prior to 2008-09.

The Near Term Outlook for the Market

As mentioned previously, the recent recovery in oil prices, coupled with the general sense that China is near a stage of economic stability or modest acceleration in growth, have improved the tone of the stock market overall. Additionally, Europe appears to be maintaining modest growth as well.

Chart III



Source: Wells Fargo

As a result, the S&P 500 is now breaking into new record levels. Chart III underscores the severity of the 2008-09 recession; we have to go back to the Volcker induced recessions of 1980-82 to see a similar economic period. As bull markets go, the current one is about seven years old. The longest running bull market to date is about 10 years. We continue to believe that the market will likely generate a flat return in 2016 within a +5% to -5% band. We draw that conclusion due to a number of factors.

- Corporate profit growth should recover from a weak 2015. Foreign exchange should be a lesser drag on earnings. Better growth in foreign markets should also be a positive.

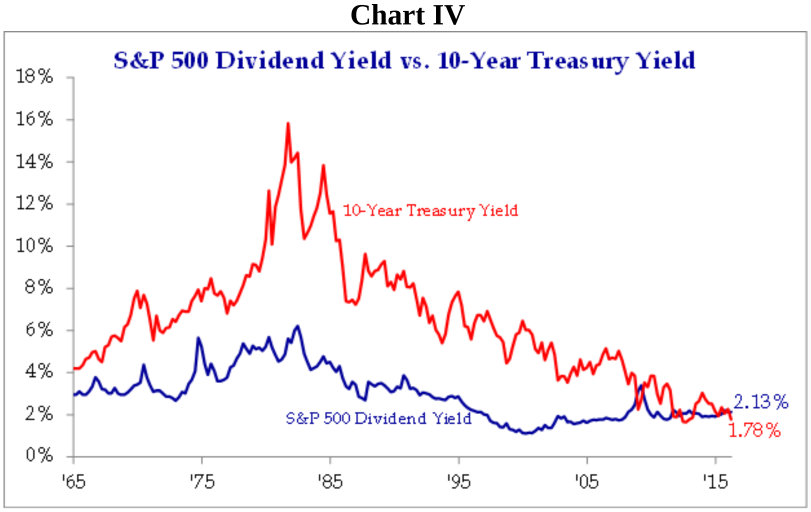
- Corporate operating profit margins appear to have peaked. Thus a strong revenue growth profile will be needed to reverse this trend. We believe that is possible in the second half of 2016.

- The Fed will likely raise interest rates only one time this year. A rising interest rate environment may have the effect of keeping equity valuations in check at current levels. However, only one more increase will be viewed as a positive for the market.

We do not believe the prospect of a recession is near. Inflation is beginning to pick up, due in large part to a full employment economy. Corporate profits are still rising. The yield curve is not inverted, and S&P 500 valuations appear reasonable. The degree of market strength may well rest on how strong corporate profit growth appears in 2016 and 2017.

<u>A Compelling Environment for Dividends?</u>

Chart IV



Source: Strategas

Dividends have always been a critical part of total return for the stock market. Usually, dividends generate 10-30% of total returns over a cycle. With interest rates so low, investors have increasingly sought out companies with yields that are above the market average. As Chart IV indicates, stocks now generate yields in excess of the 10 year Treasury rate! Our observation is that defensive yield stocks are either being underpriced or the 10 year Treasury is underpriced. Clearly, we are of the belief that this is further evidence that interest rates are too low.

Conversely, it also supports our thesis that valuations on these kinds of strong dividend paying defensive stocks are fairly valued (as opposed to many citing their elevation in premium to their historical prior peak valuation periods). Should interest rates move sharply higher, high-yielding stocks could become overvalued short term. As a result, we continue to monitor how fast the Fed will move. At this juncture, it is apparent that the Fed is clearly signaling a cautious approach to future rate increases.

As we mentioned in our last quarterly, we believe pressure will continue to mount for a more aggressive fiscal spending plan. With Republican positions leaning on stable or reduced spending and Democrats focused on spending on social programs, we see little probability of significant fiscal policy stimulus any time soon.

However, one area of increase appears to be in defense spending. We have positioned our portfolio to take advantage of the longer term growth potential in this critically important area of national security. We have also focused on companies with service models that allow for revenue growth throughout the economic cycle. Currently, we are analyzing a number of new investment themes for the portfolio.

We have attached a copy of our annual ADV brochure for your records. As always, if you wish to discuss any positions in your portfolio, our principals are available to chat about your investments.

Jack L. Salzman Senior Managing Partner	Jeffrey P. Bates Managing Partner	John A. Marshall, IV CFA, CFP® Managing Director
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